IN THE DISTRICT COURT OF THE VIRGIN ISLANDS
DIVISION OF ST. THOMAS AND ST. JOHN

CLEARWATER CONSULTING CONCEPTS, LLLP, Petitioner, v. THE UNITED STATES OF AMERICA, Respondent.	)	CIVIL NO. 2007-33
CCC HOLDINGS, LLC, Petitioner, v. UNITED STATES OF AMERICA, Respondent.	)	CIVIL NO. 2007-34

MEMORANDUM OPINION AND ORDER

This matter came before the Honorable Geoffrey W. Barnard, United States Magistrate Judge, on January 10, 2008 for oral argument on the Petitioners', Clearwater Consulting Concepts, LLLP ("Clearwater") and CCC Holdings, LLC ("CCC Holdings"), (collectively "Petitioners") Motions to Quash the Internal Revenue Service's ("IRS") third-party summonses served on FirstBank Virgin Islands ("FirstBank").[1] At the hearing, the

[1] The Petitioners filed identical Motions to Quash on behalf of CCC Holdings and Clearwater. By Order dated November 27, 2007, the court granted Petitioners' Motion to Consolidate

Petitioners were represented by Ian M. Comisky, Esq., Henry L. Feuerzeig, Esq. and Daniel L. Stackhouse, Esq. The United States of America was represented by Assistant United States Attorneys Timothy Abraham, Esq. and Thomas J. Jaworski, Esq.

At the hearing, the Petitioners called two witnesses, William L. Blum, Esq. and Theodore C. Skokos, Jr., Tax Matters Partner for Clearwater and manager of CCC Holdings. Attorney Blum testified regarding his understanding and opinion of the Virgin Islands "mirror system" of taxation and whether the Petitioners were required to dual-file Form 1065 partnership returns with the Internal Revenue Service and the Virgin Islands Bureau of Internal Revenue. Mr. Skokos testified regarding the nature of the relationship between the Petitioners and FirstBank after the summonses were issued and the types of documents that were produced to the IRS.

RELEVANT FACTS

Clearwater is a limited liability partnership created in the Virgin Islands on July 23, 2002. It offers business and management consulting and financial services in the Virgin Islands to clients worldwide. Clearwater was granted tax benefits under the Virgin Islands Economic Development

---

the cases.

Commission's Economic Development Program ("EDC Program") in December 2002. CCC Holdings is a limited liability company created in the Virgin Islands on July 23, 2002 and is a general partner of Clearwater.[2] Petitioners claim that in error they filed their 2002 partnership tax returns with the IRS, instead of the Virgin Islands Bureau of Internal Revenue ("BIR"). However, they corrected that error and at a later time, filed the returns with the BIR. Petitioners further state that they filed their 2003 and 2004 taxes with the BIR.

On November 13, 2005, the IRS issued to Clearwater a Notice of Examination and Information Document Request ("IDR") for tax year 2002. On February 6, 2006, the IRS issued Clearwater a Notice of Beginning of Administrative Proceeding for the 2002 tax year and on February 24, 2006, the IRS issued a summons to Clearwater requesting certain documents relating to tax year 2002. On August 1, 2006, the IRS notified Clearwater that it had been selected for an inquiry to determine its possible filing

---

[2] Respondent, United States of America, describes CCC Holdings as a Virgin Islands limited liability company and one percent general partner of Clearwater Consulting Concepts, LLLP which received its distributive shares of ordinary income and other incomes from Clearwater which reports income form providing consulting services to clients, including clients of the United States. (United States' Memoranda in Support of Motion For Summary Denial of Petition to Quash & Summary Enforcement of Summons, pages 2).

requirements with the United States for tax years 2003 and 2004 and also served Clearwater with an IDR for tax years 2003 and 2004. Finally, also on August 1, 2006, the IRS notified CCC Holdings that it had been selected for an audit for tax year 2002 and enclosed with the notice was an IDR for tax year 2002. On the same day, August 1, 2006, CCC Holdings was also notified that it had been selected for an inquiry for tax years 2003 and 2004 and the IRS also served an IDR for records for those tax years. (Petitioner's Omnibus Memorandum of Law in Support of Petitions to Quash Third-Party Summonses Directed to FirstBank, page 5). ("Petitioner's Omnibus Memorandum")

Petitioners contend that they cooperated fully with the IRS in its investigations. Petitioners further contend that nonetheless, on February 1, 2007, the IRS sent Clearwater and CCC Holdings a notice of and a copy of summonses served on FirstBank dated January 29, 2007. (Petitioner's Omnibus Memorandum, page 6). On February 20, 2007, Petitioners filed these Petitions to Quash the IRS third-party summonses on FirstBank alleging that the summonses were not issued in accordance with the criteria set forth in *Powell v. United States*, 379 U.S. 48(1964). The Petitioners allege that the summonses do not meet any of the requirements of Powell and must be quashed for the following reasons: (1)the IRS is illegitimately using the Tax Equity and

Fiscal Responsibility Act of 1982,("TERFA"), Internal Revenue Code §§ 6221-6324, partnership audit procedures with respect to Clearwater in an attempt to "look through" the Virgin Islands entities to attack the residency of individual partners in violation of the Tax Implementation Agreement ("TIA")between the Virgin Islands and the United States; (2) the vast majority of Clearwater and CCC Holdings records sought from FirstBank are already in the possession of the IRS; and (3) the IRS did not provide reasonable advance notice of third-party contacts as required by 26 U.S.C. § 7602(c)because it provided no notice to CCC Holdings and unreasonable notice to Clearwater. (Petitioners' Onmibus Memorandum, page 2).

On May 21, 2007, the United States of America ("Respondent" or "IRS") responded to the Petitioners' Omnibus Memorandum.[3] Specifically, the IRS contends that it is investigating the reporting requirements of CCC Holdings and Clearwater and whether they have reported the proper amounts of income and the source of such income for the 2002 through 2004 tax years and that the records sought from FirstBank are necessary in its determination of whether the income earned by Clearwater during 2002, 2003 and/or 2004 tax years is U.S. sourced or effectively connected

[3] The Respondent filed two memoranda, one respective to CCC Holdings and the other applicable to Clearwater.

income and whether the income earned by CCC Holdings during 2002, 2003, and/or 2004 tax years are United States sourced income or effectively connected income. (Respondent's Memoranda, pages 3).

Respondent further alleges that pursuant to 26 U.S.C. §6031(e)(2), a foreign partnership is required to file a Form 1065(U.S. Partnership Return) if it has gross income derived for sources within the United States, or gross income which is effectively connected with the conduct of a trade or business conducted in the United States. (Respondent's Memoranda, pages 3). Respondent further alleges that income from services are sourced where the services are provided; therefore it is necessary to determine where Clearwater consultants provided their services[4] and if the income is U.S. sourced, CCC Holdings and Clearwater were required to file United States partnership tax returns reporting U.S. and non-U.S. income and if CCC Holdings and/or Clearwater received U.S. sourced income for the 2002, 2003 and/or 2004 tax years, that income must be identified on the BIR tax returns and is not available for the computation of the Economic Development credit by the partners. (Respondent's Memoranda, pages 3 and 4).

---

[4] Respondents state that many of the consultants of Clearwater are also partners of CCC Holdings. (Respondent's Memorandum regarding CCC Holdings, page 4).

Respondent further contends that it followed all the administrative steps as required by the Internal Revenue Code ("IRC")and the summonses seek documents that are relevant and necessary to the IRS's investigation of the reporting requirements of Petitioners and whether CCC Holdings and/or Clearwater reported the proper amounts of income and the source of such income for tax years 2002 through 2004. (Respondent's Memoranda, pages 4). Finally, Respondent contends that although, the Petitioners produced various documents in response to its pre-summons requests, the documents contained some, but not all, of the documents records reflecting the details of funds activity. (Respondent's Memoranda, pages 5 and 6).

In their reply, Petitioners contend that Respondents' assertion that partnerships formed and existing solely in the Virgin Islands are subject to dual-filing requirements ignores the mirror tax system, fails to address the IRS's illegitimate use of TERFA Audit Procedures and is legally incorrect and is made in bad faith.

DISCUSSION

The question before this Court is whether the IRS has met the criteria set forth in *Powell* for the issuance of summonses and whether the Petitioners have set forth appropriate grounds to establish that the IRS has not met the *Powell* requirements. The

criteria set forth in *Powell v. United States* for the issuance of a valid summons, are as follows: (1) the summons must be issued for a proper purpose, (2) the information sought must be relevant to that purpose, (3) the information must not be in the possession of the IRS and (4) that the administrative steps required by law regarding the summons and the issuance and the service of the summons must have been followed. *Powell* at 57-58.

I.

A. In regard to the first prong of the *Powell* criteria, Petitioners contend that the IRS's issuance of the summonses does not meet the first criteria of the Powell test in that the summonses were not issued for legitimate purposes. The Petitioners set forth several grounds in support of this proposition. First, the Petitioners allege that the TEFRA partnership audit rules do not apply to the 2003 and 2004 tax years inquiry of Clearwater. Second, Petitioners allege that only the residency of the partnership, Clearwater, and its general partner, CCC Holdings, is relevant and it is undisputed that these entities are Virgin Islands residents and, thus, the IRS has improperly issued summonses and is improperly attempting to avoid the Tax Implementation Agreement ("TIA").

In regards to its first argument, Petitioners state that in absence of an audit, TERFA procedures do not apply and that

Clearwater and CCC Holdings are being audited for the 2002 tax year only and the IRS is merely conducting an inquiry for the 2003 and 2004 tax years and thus, the TERFA procedures do not apply to the 2003 and 2004 inquiries. Further, Petitioners contend that in other Virgin Islands tax controversy cases, there was a dispute regarding the residency of the taxpayers; however, here, there is no controversy about residency of Clearwater and CCC Holdings[5], as they are bona fide Virgin Islands partnerships and as bona fide partnerships/residents, the "mirror code" systems, codified at 48 U.S.C. 1397,[6] controls their tax filing requirement and Clearwater and CCC Holdings would fulfill their U.S. tax obligation by filing their tax returns and paying all their income taxes into the Treasury of the Virgin Islands.

B. Additionally, Petitioners allege that they are not aware

---

[5] Although CCC Holdings is a limited liability company, it has elected to file its returns as a partnership. (Petitioners' Omnibus Reply, page 14.)

[6] **Income law of the United States in force; payment of proceeds; levy of surtax on all taxpayers**
The income-tax laws in force in the United States of America and those which may hereafter be enacted shall be held to be likewise in force in the Virgin Islands of the United States, except that the proceeds of such taxes shall be paid into the treasuries of said islands: Provided however, That, notwithstanding any other provision of law, the Legislature of the Virgin Islands is authorized to levy a surtax on all taxpayers in an amount not to exceed 10 per centum of their annual income tax obligations to the government of the Virgin Islands.

of any other instance in which the IRS has taken the position that bona fide Virgin Islands partnerships are subject to a dual filing requirement as a foreign partnership under Internal Revenue Code § 6031(e)(2). In support of their position that the dual filing is not required, the Petitioners contend that there is no form to report sourcing of income for foreign partnerships as there are for individual taxpayers, such as the 1040 Info. Further, the Petitioners argue that the returns they filed with the BIR, of which the IRS has copies which were provided to it by the Petitioners, contain the partners' worldwide income and the Schedules K-1s of its partners and under dual filing, the Petitioners would be required to file only the Schedule K-1 with its U.S. returns. Thus, Petitioners contend that Clearwater and CCC Holdings returns filed with the BIR are more comprehensive than if they were filing U.S. returns and that the IRS may readily obtain the information by requesting copies of the Schedule K-1s from the BIR pursuant to Article 4 of the TIA. Further, Petitioners argue that it is impossible for CCC Holdings to have income other than Virgin Island source income in that it is the general partner of Clearwater, a Virgin Islands partnership, and receives all its distributions from Clearwater. Therefore, all of CCC Holdings income is Virgin Islands source income.

C. Petitioners' last contention in support of its position that the Respondent has failed to meet the criteria of the first prong of the *Powell* test, is that the IRS has violated the TIA. Petitioners assert that notwithstanding Article 4,paragraph 4, of the TIA, a reservation clause that allows the IRS to exercise its rights under § 7602[7] of the Internal Revenue Code without

---

[7] Section 7602 in pertinent part reads:

Examination of books and witnesses.

(a) Authority to summon, etc. For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, the Secretary is authorized--

(1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry;

(2) To summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the Secretary may deem proper, to appear before the Secretary at a time and place named in the summons and to produce such books, papers, records, or other data, and to give such testimony, under oath, as may be relevant or material to such inquiry; and

(3) To take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry.

(b) Purpose may include inquiry into offense. The purposes for which the Secretary may take any action described in paragraph (1), (2), or (3) of subsection (a) include the purpose of inquiring into any offense connected with the administration or enforcement of the internal revenue laws.

(c) Notice of contact of third parties.

(1) General notice. An officer or employee of the Internal Revenue Service may not contact any person other than the taxpayer with respect to the determination or collection of the tax liability of such taxpayer without providing reasonable notice in advance to the taxpayer that contacts with persons other than the taxpayer may be made.

(2) Notice of specific contacts. The Secretary shall periodically provide to a taxpayer a record of persons contacted during such period by the Secretary with respect to the determination or collection of the tax liability of such taxpayer. Such record shall also be provided upon request of the taxpayer.

(3) Exceptions. This subsection shall not apply-

(A) to any contact which the taxpayer has authorized;

complying with procedure set forth in the TIA, the IRS was required to request needed information from the BIR before issuing the summonses to FirstBank. Petitioners further contend that the reservation of rights clause does not apply for the following reasons: (1)because the language of the TIA is limited to information in the Virgin Islands and the information in this case is requested from the FirstBank in Puerto Rico; (2) that the IRS has successfully invoked the clause only in cases that involve the issue of residency of the taxpayer; (3) that to the extent that the clause may be applicable, the TIA only preserves it authority under § 7602 and the strictures of § 7602 are not satisfied in that there was no request for a summons from the BIR and there is not a legitimate inquiry into the bona fide Virgin Islands status of the taxpayer; (4) the reservation clause itself limits the right for the IRS to act outside of the BIR only to the extent that the IRS notifies the BIR before taking action or as soon a practicable, unless the IRS and BIR agree to limit notification to certain classes of cases; and finally, (5) that the actions of the IRS in this case do not fit the "necessity"

(B) if the Secretary determines for good cause shown that such notice would jeopardize collection of any tax or such notice may involve reprisal against any person; or

(C) with respect to any pending criminal investigation.

exception of § 7602.

The IRS on the other hand contends that the summonses were issued for a proper purpose in that summonses were issued to investigate Petitioners' reporting requirements and whether Petitioners reported the proper amounts of income and the source of the income for the tax years 2002 through 2004 pursuant to 26 U.S.C. §6031(e)(2)[8] and 26 U.S.C. 863,864. The IRS concedes that the residency of the partners is relevant to the extent it may indicate where the consultants of Clearwater, most of whom are also partners of CCC Holdings, provided services in order to determine whether Clearwater failed to report U.S. sourced income or income effectively connected to a U.S. trade or business. (Respondent's Memoranda pages 11).

1. Petitioners' first argument is that the IRS does not

---

[8] **Foreign Partnerships.-**

(1) Exception for foreign partnership.-Except as provided in paragraph (2), the preceding provisions of this section shall not apply to a foreign partnership.

(2) Certain foreign partnerships required to file return. Except as provided in regulations prescribed by the Secretary, this section shall apply to a foreign partnership for any taxable year if for such year, such partnership has-

(A) gross income derived from sources within the United States, or

(B) gross income which is effectively connected with the conduct of a trade or business within the United States.

The Secretary may provide simplified filing procedure for foreign partnerships to which this section applies.

have authority under TERA to "audit" or conduct an inquiry for tax years 2002 through 2004 because no "returns" were filed with the IRS for those years and therefore, in absence of a United States' return, TERA does not apply and there can be no audit.[9] The court notes that Clearwater and CCC Holdings filed returns with the IRS and BIR in 2002 and with the BIR for 2003 and 2004. The court further notes that CCC Holdings is a bona fide limited liability company that files its taxes as a partnership and that Clearwater is bona fide Virgin Islands partnership. As such, Clearwater and CCC Holdings are properly considered foreign partnerships within the meaning of 26 U.S.C. §3061(e)(2). The court further notes that whether the Respondent has authority to conduct an audit/inquiry of the Respondent on the facts of this case is not dispositive to issue before the court. The court finds that the Petitioners are foreign partnerships within the meaning of 26 U.S. C. 603 (e)(2) and as foreign partnerships, the Respondent has the authority under 26 U.S.C. section (e)(2) to investigate the Petitioners whether designated as an audit or as an inquiry to determine if any of Petitioners' gross income was derived from sources within the United States or if any of their gross income was effectively connected with the conduct of trade

[9] As noted above returns were initially filed with the IRS, but were subsequently filed with the BIR.

or business conducted in the United States.

2. Petitioners next argue that because they are bona fide Virgin Islands partnerships, the mirror tax system applies. As such, the Petitioners are only required to file their tax returns with the Virgin Islands government. In support of this argument, the Petitioners cite several cases. Particularly, the Petitioners cite *Polychrome International Corporation v. Krigger*, 5 F.3d 1522 (3d Cir. 1993)for the proposition that foreign sales corporations incorporated in the Virgin Islands are obligated, in the absence of any special exemption, to pay income taxes to the Virgin Islands government under the "mirror code" provision, 13 U.S.C.1397 (1988), which make the IRC applicable to all Virgin Islands residents. *Polychrome* at 1527. This essentially means that an individual or a corporation in the Virgin Islands pays its taxes to the BIR as an individual or a corporation under the same circumstance would pay its taxes to the IRS. *Id.* Most interestingly though, the court in *Polychrome*, in footnote 8, notes "[a]lthough individuals paying taxes under the mirror code provision are normally not required to pay taxes to the United States, the FSC provisions in the IRC provide that no tax imposed by §§ 921-927 must be "covered over" (i.e., not payable to) the Virgin Islands government. See IRC § 927 (e)(5)(c)." *Polychrome* at 1527, n. 8. It should be further noted that the exempted

portion of FSCs income is treated as "foreign source income which is not effectively connected with the conduct of trade or business with the United States." Polychrome at 1527, n. 6.

Thus, as evidenced in *Polychrome*, although the Virgin Islands FSCs were required to pay its taxes to the Virgin Island government, they were certain types of taxes that were still payable to Untied States Government. Likewise, is the case before us. Accordingly, pursuant to 26 U.S.C. 3601(e)(2), Petitioners are required to file tax returns for any income earned from sources within the United States or on gross income effectively connected with the conduct of a trade or business in the Untied States. Petitioners' arguments that this is the first time that the IRS has attempted to enforce this provision; that there are not separate IRS or BIR forms to list United States gross income from sources within the United States or gross income effectively connected with the conduct of trade or business conducted in the United States and that they are not aware of regulations, rulings or IRS guidance prescribing, nor any case holding that bona fide Virgin Islands partnerships are subject to a dual filing requirement under 26 U.S.C. 3061(e)(2) does not, in this court's opinion, affect the enforceability of the provision nor estop the government from enforcing the provision.

3. Finally, the Petitioners assert that the TIA is on the facts of this case. First, Petitioners contend that the TIA is not applicable because the summonses were issued to the FirstBank in Puerto Rico and not Virgin Islands Branch. In Respondent's memoranda, Respondent asserts that the summonses were issued to the Puerto Rican branch of FirstBank because the bank's legal counsel's division is located there. The court disagrees with the Petitioners' asserting that the TIA is not applicable because the summonses were sent to the Puerto Rican branch office FirstBank and not to the St. Thomas branch. Albeit, the summonses were sent to the Puerto Rican branch, the summonses requested information generated in the Virgin Islands for CCC Holdings and Clearwater. Thus, to the extent the summonses requested information about Virgin Islands residents and is merely addressed to the Puerto Rican branch of FirstBank because the legal counsel's office is in Puerto Rico, the finds that the request does not violate the spirit of the TIA agreement.

Secondly, Petitioners assert that the IRS has only successfully invoked the applicability of the TIA reservation clause on the issue of residency of the taxpayer. Even given this statement to be true that in and of its self is not disposition of the issue. The IRS, under 7602, has several grounds to initiate an investigation of a taxpayer and the court

finds that this investigation of the Petitioners falls within the parameter of 7602. The court specifically rejects the Petitioners assertion that in absence the IRS's request from the BIR to issue a summons or an inquiry into the residency status of the partnerships, the IRS does not have a basis under 7602 to investigate the Petitioners.

Finally, the Petitioners contend that the IRS does not have authority to request information of Virgin Islands taxpayer without first notifying or as soon as practicable thereafter notifying the IRB of its request. Petitioners have not submitted any affidavit or other document to establish that the IRS did not first notify the BIR before proceeding with the issuance of the summonses. The Petitioners have merely asserted in their memoranda that "to petitioners' knowledge, there has been no request to or from the Virgin Islands government for assistance." In the absence of an affirmative assertion that the TIA has not been complied with, the court finds that the provision has not been complied with. Finally, as the court finds that the TIA agreement is applicable here, it does not need to address Petitioners fifth contention.

II.

Petitioners contend that the IRS fails to meet the second prong of the *Powell* test in that IRS has in its possession documents

that it requested pursuant to the summonses. In support of their position, the Petitioners cite *United States v. Monumental Life Insurance Company*, 440 F.3d 729 (6th Cir. 2006). In that case, the court held that Monumental Life Insurance Company, the third-party, was not required to produce documents that the IRS already had in its possession as the documents were produced by Monumental to the IRS with regards to the IRS's investigation of another company. The distinguishing factor between that case and here is that in *Monumental*, the IRS had obtained the requested documents from Monumental relative to the IRS's investigation of different company regarding the same issues. Here, the IRS received the document from CCC Holdings and Clearwater only and had not received the documents in a prior investigation from FirstBank. The court notes and agrees that the IRS should be able to independently verify the completeness and accuracy of the documents produced by Clearwater and CCC Holdings. See *United States v. Davey* 653 F.2d 996 (2d Cir. 1976). Thus, its request for documents from FirstBank that it may have already received from the Petitioners, under this circumstances, is not violative of *Powell*.

III.

Finally, the Petitioners argue that the IRS did not provide sufficient notice to the Petitioner regarding it intent to serve

summonses on FirstBank. Specifically, they allege that the Publication 1 enclosed with the August 1, 2006 letters for the 2003 and 2004 notices of inquiry were not sufficient to put the Petitioners on notice that the IRS had the right to contact third-parties. Further with respect to the letters sent in March 2006 advising of the possible third-party contacts for the 2002 tax year examinations, Petitioners argue there was an unreasonable ten-month delay between their receipt of the letters and the date the summonses were served and that they had produced documents in the interim and were never advised that their production was deficient in any manner.

In support of its position the Petitioners cite *United States v. Jillson*, 84 A.F.T.R.2d 99-7115 (S.D. Fla. 1999) and recites the legislative history of section 7602(c). The court notes that in *United States v. Jillson*, the contact letter was not sent until after the summonses were issued. This is not the case here; in this case, the contact letter and the Publication 1s advising of potential third-party contact were sent before the summonses were issued. The legislative history acknowledges that the taxpayer has a right to know of third-party contacts before they occur and gives the taxpayer the opportunity to volunteer information and to resolve issues before third-parties are contacted.

Here, the court finds that the letters sent to the Petitioners in March 2006 regarding potential third-party contact for the 2002 tax year examination and the Publication 1s sent regarding the 2003 and 2004 notices of inquiry were sufficient notice to the Petitioners. Further, the court also finds that the timing of March 2006 letters and the sufficiency of Publication 1s notice to the third-party contacts were not violative of the intent of section 7602 as articulated in the legislative history.

CONCLUSION

For the foregoing reasons, the Petitioners' Motions to Quash the Third-Party summonses issued on FirstBank are **DENIED** and the United States' counterclaim to enforce the summonses is **GRANTED.**

DATED: July 22, 2008

S_____
GEOFFREY W. BARNARD
U.S. Magistrate Judge

ATTEST:
WILFREDO F. MORALES
CLERK OF THE COURT